

## China: Annual economic report – November 2008

### 1. Appreciation of the economic problems and issues

After five years in a row with double digit growth, China's economy shrank during 2008. Economic growth slowed to a year-on-year expansion of 9% in the third quarter, after a growth of 10.6% in the first quarter and 10.1% in the second quarter. **The economy expanded at an annual rate of 9.9% in the first nine months of the year**, compared to 11.9% for the whole 2007.<sup>1</sup>

Growth of 9% in the third quarter was slower than expected. This **downturn is mainly due to a decrease in industrial production and construction**. Many factories were forced to close down during the Beijing Olympics – in order to improve air quality – and the financial crisis led to a drop in external demand. Domestic investment slowed down due to a slide in the property market.

After the release of the third quarter statistics, the State Council – China's highest government body – immediately announced to **adopt “flexible and prudent economic policies” in order to “maintain the stable and rapid growth of the economy”**. China's government fears joblessness as this could lead to social unrest. Therewith the major economic concern of the Chinese government has shifted quickly from controlling inflation and excess demand to maintaining growth. The government announced increases in export tax rebates on more than 3000 products, including labour-intensive products like garments and textiles as well as high value products like mechanical and electrical products.<sup>2</sup>

Despite the weakness in the global economy, the merchandise trade surplus reached a new monthly record of US\$ 29.3 billion in September.<sup>3</sup> Trade grew by 25.2% year-on-year in the first three quarters, up 1.7 percentage points compared to the same period last year. While exports went up by 22.3% year on year, a drop of 4.8 percentage points compared to last year, imports grew by 29%, a rise of 9.9 percentage points. In the third quarter import growth slowed down from the rapid rates recorded in mid-year reflecting a fall in commodity prices and therefore improving China's net trade.

**However, as demand from China's most important trading partners – the European Union and the USA – is declining in the wake of the financial crisis, China's export market is starting to suffer.** China's manufacturing contracted the most last month and stories about SMEs closing down are accumulating. With the recent milk powder scandal<sup>4</sup> the “Made in China”-label experienced a further blow. Although China's dairy exports are small, the country is one of the world's largest exporters of food and food ingredients and corresponding companies are affected by global recalls of goods.

Beijing's efforts to support domestic exporters could renew international attention and calls for protection against Chinese imports. Analysts say the government might soon shift the country's currency policy toward slowing the yuan's appreciation against a basket of currencies. This would allow the yuan to weaken slightly against the dollar. After having appreciated 7.3% against the dollar since the beginning of this year, further appreciation stalled since mid-July.<sup>5</sup>

**Inflation fell to 4.6% in September, down from a 12-year high of 8.7% in February.** This change is attributed mainly to slower growth in food prices. Bad weather at the beginning of this year had caused food prices to go up and therefore the Chinese government had faced an inflationary problem. The government had introduced price controls and subsidies aiming at expanding farm production in order to combat inflation. However, the price of pork remains high. **Despite the fall in consumer price inflation, inflationary pressure remains.** Producer price inflation rose by 6.9% year-on-year, or 3.7

<sup>1</sup> National Bureau of Statistics of China: Steady and Fast Growth in the First Three Quarters of 2008, 20 October 2008.

<sup>2</sup> Xinhua, 21 October 2008.

<sup>3</sup> Financial Times, 13 October 2008.

<sup>4</sup> Melamine, a chemical substance traditionally used to produce durable dishware, was used to make the protein content in foods appear adequate and has been added to mainland milk and milk-powder products.

<sup>5</sup> “China's yuan may weaken against dollar, Standard Chartered says”, Bloomberg, 23 October 2008.

percentage points higher than in the same period last year, increasing the possibility that producers might pass on higher prices to their customers. Still, due to high competition between producers this seems unlikely.

According to official figures, **consumer spending is still doing well** and retail sales of consumer goods went up 22.0% in the first three quarters, 6.1 percentage points higher than in the same period last year.<sup>6</sup> Although sales of cars and home-appliances drop sharply, overall retail sales have remained strong particularly because of a **strong increase in rural spending**.

**China's stock market** - one of the best-performing markets in the world in 2006 and for most of 2007-**has fallen by over 60% since its peak in October 2007.**<sup>7</sup> This fall has come although the government told fund managers not to sell equities and start buying again. Other moves to support the equities market include the abolishment of a stamp duty tax on share purchases by the government and the temporary suspension of trading fees for bond transactions at the Shanghai Stock Exchange.<sup>8</sup> Moreover, **China is beginning to suffer from its property market downturn.** Although housing prices are still 5.3% higher in year-on-year terms, this is the slowest rate of increase in 18 months. In a move to support the property market the government announced a series of measures including a reduction in down payment requirements, a cut in interest rates on mortgages for first time buyers, a cut in stamp duty and the capital gains tax on property sales. Further, the government will encourage construction of low-rental housing and boost subsidies for lower-income households.<sup>9</sup> However, experts expect that the government will have to introduce further measures in the future as many home buyers are unwilling to purchase new homes until market prices fall to an affordable level.

**Falling inflation and a worsening global outlook have led to an easing of monetary policy.** The People's Bank of China (PBoC, China's central bank) has cut interest rates three times since September.<sup>10</sup> Over a period of three years, the Chinese government had tightened monetary policy and the PBoC had kept interest rates on hold since December 2007. The move came when a number of China's big industrial companies reported lower third quarter results and announced production cuts. According to the PBoC, the decision to cut interest rates is part of a **flexible monetary policy to cope with the world financial crisis and to boost the domestic economy.** The PBoC had already cut the reserve requirement ratio by 0.5 percentage points lowering the ratio for the six biggest banks to 17% and that for smaller banks to 16% in October.<sup>11</sup> In a further effort to support the domestic economy and pump liquidity into the market, the PBoC decided at the beginning of November to stop capping the amount of loans that commercial banks can make. Strict limits on the amount of new loans were set in late 2007 in order to avoid an overheating of China's economy.<sup>12</sup>

While for much of the past year, **China had stayed nearly unaffected to the problems in the international credit markets there had been growing signs in recent weeks that the economy might fall more sharply than expected.**

Although China's direct exposure to the financial turmoil in the U.S. and Europe is limited as financial linkages are relatively weak some Chinese banks hold equities issued by financial institutions which have gone bankrupt.<sup>13</sup> With its US\$ 1.9 trillion foreign exchange reserves the country is seen as a source of stability and is well positioned to expand its influence. At this year's ASEM meeting taking place in October in Beijing, China agreed to actively cooperate with the EU. Nevertheless, the Chinese government sees its principal contribution in resolving the crisis by sustaining high growth and likely doesn't want any international institutions to interfere into its financial market.

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<sup>6</sup> National Bureau of Statistics of China: Steady and Fast Growth in the First Three Quarters of 2008, 20 October 2008.

<sup>7</sup> UBS Asian Economic Monitor, 3 November 2008.

<sup>8</sup> EIU Country Report, November 2008.

<sup>9</sup> "China cuts deposit payments, mortgage rates on homes", Bloomberg, 22 October 2008.

<sup>10</sup> As of October 30, the benchmark one-year deposit rate dropped to 3.6% from 3.87% and the benchmark one-year lending rate fell from 6.93% to 6.66%.

<sup>11</sup> People's Bank of China, 8 October 2008 (<http://www.pbc.gov.cn/english/detail.asp?col=6400&ID=1172>).

<sup>12</sup> Wall Street Journal, 3 November 2008.

<sup>13</sup> EIU Country Report, November 2008.

Many economists are expecting lower levels of growth of between 6 to 8% next year as the country's major export markets are facing an ever-worsening outlook. Due to the weakness in the country's property, automotive and export-oriented manufacturing sectors investment growth is expected to fall further. However, the government has means to support domestic demand by enhancing fiscal spending and adopting economic policy changes.

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## 2. International and regional economic agreements

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### 2.1 Country's policy and priorities

#### China as a member of the World Trade Organisation (WTO)

Since China's accession to the WTO in 2001, the country has implemented almost all of its WTO commitments and has made significant progress in many areas. Foreign companies have continued to profit from reduced tariffs, the elimination of import licences and quotas, the opening of more sectors for foreign participation (especially services sectors), and the easing of restrictions on business operations. Nevertheless, concerns relating to market access remain, but they are now focused on China's laws, policies, and practices that deviate from the WTO's national treatment principle, the insufficient protection of intellectual property rights, the deficient transparency of legal and regulatory processes, and the opaque development of technical and product standards that may favour local companies. There have been various trade disputes in 2007 – for example by the US or the EU – but this has not led to major conflicts. Most of the trade disputes that have occurred in the last six years, have had more to do with market access for investment rather than for importing goods into China or for issues only indirectly related with trade such as the use of subsidies and the production of counterfeit goods. China's trading partners are concerned about the creation of non-tariff barriers and China's resistance to properly cope with prevalent intellectual property piracy, counterfeiting, and the prohibited subsidies. China further creates various new measures to prevent foreign companies from entering the Chinese market such as new requirements for state control of "critical" equipment manufacturers or restrictions on foreign providers of financial information services.<sup>14</sup>

Under its WTO accession commitment, China has started opening up its banking industry to foreign competition in December 2006. Having progressively relaxed restrictions over the past five years, China allows foreign banks **access to its RMB retail business and lifts all geographic and client constraints** on their operations, eliminating any existing non-prudential measures restricting ownership, operations, internal branching and licenses.<sup>15</sup> The revised Regulation on the Administration of Foreign-funded Financial Institutions by the State Council also allows **subsidiaries of foreign banks** to offer foreign exchange and RMB services to all customers, meaning both corporate and retail customers just as domestic banks, and also permits **branches of foreign banks** to continue doing foreign exchange business with all customers and RMB business with foreign and Chinese enterprises as they did before.<sup>16</sup> Another obstacle for foreign banks will be the licensing and approval process for individual business lines and branch networks. So far, 21 foreign banks - none of them Swiss - have been allowed to incorporate their Chinese branches into subsidiaries.

So far, China has leant towards being an **advocate of free-trade** within the WTO, demonstrating a strong engagement in issues typically affecting emerging markets – also in the context of its involvement with the Group of 20 developing countries (G 20) led by Brazil – such as the liberalisation of agricultural markets. China wants to give the image of an active WTO-member but has so far been criticized for not engaging hard enough to find a compromise on Doha.

Following the **suspension of the Doha round talks** in July 2008, China expects first the US and then the EU to take major steps to unlock negotiations, thus opening the door to G20 and G33 concessions. While China keeps engaging in multilateral trade discussions and protecting its interests within the WTO it has also started bilateral trade deals and free-trade agreements (FTAs) with strategic partners. As China has become a dominant trading nation, the government sees bilateral accords as a useful tool for pursuing the country's strategic interest.

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<sup>14</sup> Economic Intelligence Unit, China Hand, February 2008.

<sup>15</sup> Special Comment on „China's Banking Sector Opening Under WTO Commitments“, Moody's Investors Services – Global Credit Research, November 2006.

<sup>16</sup> China Banking Regulatory Commission Chairman Liu Mingkang's speech about the newly revised Regulation on the Administration of Foreign-funded Financial Institutions by the State Council, 15 November 2006.

## China-ASEAN Free Trade Agreement (CAFTA)

After its successful accession to the WTO, China turned itself to ensuring the conclusion of regional free trade agreements. In November 2001, China and ASEAN began negotiations to set up a free trade agreement. One year later, a framework agreement laying out the CAFTA plan was signed. The CAFTA, a zero-tariff market has targeted to come into force in 2010 for the six original ASEAN members (Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand) and in 2015 for the newer and less developed members (Cambodia, Laos, Myanmar, Vietnam). The framework agreement states the objectives of the group with China and **aims to lower bilateral tariffs to 0-5% on most goods and eliminate non-tariffs barriers**. However, it doesn't detail the FTA's institutional set-up, relying on future consultations. The negotiations ended in October 2004 and the partners signed several trade pacts a month later at the ASEAN-meeting in Vientiane, Laos. The tariff reduction programme was launched in July 2005, the start of a comprehensive implementation of CAFTA.

While China continuously tries to convince the ASEAN countries of the mutual benefits of closer trade relations, the latter feel **growing concern at perceiving the suction-effect** that the industrial site that China is, has on attracting foreign direct investment. Meanwhile, Japan and the USA also see their position as regional economic super-powers challenged and consequently put an effort to reach a free-trade agreement with the ASEAN-countries themselves.

It follows from China's tightening ties with ASEAN that the country would **press further regionalism**. China has supported the transformation of ASEAN+3 (China, South Korea and Japan) into the East Asian Summit (EAS), which has welcomed Australia, New Zealand and India to the group during its inaugural meeting on 14 December 2005 in Malaysia.

Substantive progress has been made between the ASEAN members and China in the negotiations on the **Bilateral Investment Pact** which is expected to be signed at the Bangkok Summit in December 2008. The investment pact is one of the three components of the bilateral free trade agreement. The other two are the **Trade in Goods Agreement** and the **Trade in Services Agreements** which were concluded in 2004 and 2006 respectively. China and ASEAN members also finalized two Memorandum of Understanding (MOU), one on cooperation on intellectual property and one on technical barriers to trade. At the same time the leaders of the ten ASEAN member countries affirmed their strong commitment to **accelerate the establishment of a FTA with China by 2015**.

## Other international free trade negotiations

- China and **Chile** signed a FTA at the APEC-Summit in Busan, South Korea, in November 2005 (only a year after negotiations started) which has come into effect on 1 October 2006 and will eventually lift customs fees on the trade of 97% of all trade goods. Bilateral talks on a FTA in services started in January 2007, the sixth round of talks took place in March 2008 and negotiations are expected to finish in 2008. On 13 April 2008, China and Chile signed an agreement on free trade in services. The two nations committed themselves to opening up their service sectors in accordance with World Trade Organization rules, under a supplementary agreement to their formal free-trade pact signed in 2005. The service free-trade covers 23 sectors in China, including computers, management consulting, mining, sports, environment and air transport, the official Xinhua news agency reported.
- After 15 rounds of negotiations, China and **New Zealand** signed a free trade agreement on 7 April 2008. This is the **first FTA China signed with a developed country**. Talks on the agreement had started in 2004 after New Zealand became the first rich country accepting China as a market economy. Under the FTA, New Zealand will phase out all tariffs on imports from China (textiles, clothing and footwear) until 2016. China will remove tariffs on 96% of its imports from New Zealand until 2019 with tariffs on some products (especially dairy products, meat, wool, etc.) being cut to zero. **Beyond trade in goods, the agreement covers the services sector**, from insurance and banking to education and labour supply as well as investment. The FTA came into force on 1 October, 2008.
- Comprehensive China - **Australia** FTA-negotiations were launched in April 2005, but due to substantial stumbling blocks, namely in agriculture and industrial goods, are making relatively slow progress. During the tenth round of negotiations, taking place at the end of October 2008, the parties were able to reduce some difference meanwhile overall progress in the negotiations continued to be slow.

- After five rounds of negotiations since April 2005, China and **Pakistan** have agreed on market access and signed a FTA on 24 November 2006. Under the agreement China and Pakistan will reduce or eliminate tariffs on all products in two phases, the first phase began on 1 July 2007. In the first five years both sides will cut tariffs on imports in five categories up to 85 percent. The second round of talks on the “services” chapter was held in August 2007.
- In May 2007 China and **Peru** launched a first joint feasibility study in Beijing with the aim to conclude the study within three months. In January 2008 a first round of talks took place. Both sides decided to boost bilateral trade and investment in the coming months, ahead of the free trade deal planned to ink in November during the annual Asian-Pacific Economic Cooperation (APEC) forum.
- China and **Switzerland** decided in July 2007 to look on both sides into the feasibility of a possible FTA.
- China and **South Korea** conducted two rounds of joint research in 2005 and 2006 which will form the basis for exploring the possibility of initiating FTA negotiations. The last round of talks on a joint study of an FTA took place in October 2007.
- China has also started negotiations on a bilateral FTA with the **Gulf Cooperation Council** (GCC) and plans to follow suit with **MERCOSUR**, and the **Southern African Customs Union** (SACU).
- **Hong Kong** expanded a free-trade deal with mainland China on 29 July 2008 in an agreement that includes giving mining and exploration companies and related services easier access to the Chinese market.
- **India** and China have completed a feasibility study on their proposed Free Trade Agreement. It now awaits the approval of the leadership of the two countries to take it to the next level so that steps to conclude the Free Trade Agreement can be taken at the earliest, Xinhua stated on 11 October.
- China signed on 17 October 2008 a trade deal with **Senegal** to offer zero-tariff treatment to more than 400 categories of goods imported from Senegal. It is expected, that the trade deal will elevate their bilateral trade and economic ties to a new stage.
- China and **Singapore** signed a bilateral free trade agreement (FTA) on 23 October 2008. Negotiations for the China-Singapore FTA began in October 2006. The FTA covers trade in goods, rules of origin, trade remedies, trade in services, movement of natural persons, investment, customs procedures, technical barriers to trade, sanitary and phytosanitary measures and economic cooperation.

## 2.2 Outlook for Switzerland (potential for discrimination)

In the bilateral agreement to China's WTO-accession of 26 September 2000, the People's Republic had agreed to make certain concessions towards Switzerland in the fields of insurance licences, inspection services and the import of watches. In the beginning, these privileges have only partly been taken advantage of. Economic difficulties of companies' headquarters in Switzerland have played a role in this, as well as in determining whether to reduce temporarily or give up completely the work in the Chinese market. On the other hand, **some sectors have benefited from such easing of market entry rules**: for example, representing the reinsurance sector, Swiss Re officially opened the company's China branch in December 2003. In May 2006 Zurich Financial Services Group received approval to run a property and casualty branch in Beijing, thus becoming the first foreign insurer to establish a general insurance branch in the capital. Swiss financial intermediaries have also strengthened their foothold in mainland China while Hong Kong remains the leading financial centre. At the beginning Swiss watch imports have profited from reduced tariffs. However, the sudden introduction of a 20% consumption tax on luxury watches as of 1 April 2006 has had a certain negative impact on mainland sales figures. This tax affects watches with a value of RMB 10'000 (approx. CHF 1'600) or more, of which 99% are Swiss made.

In July 2005 Switzerland and the other three members of the European Free Trade Association (EFTA) proposed China to consider a feasibility study about an FTA. In subsequent meetings the Chinese side stated that the idea of an **EFTA-China FTA “should be considered very seriously”** but that it faced serious resource-constraints due to the Doha Round and an increasing number of bilateral free trade negotiations. Although China reconfirmed in December 2006 to be basically willing to conclude an FTA with all EFTA members, it doesn't seem to want negotiations with the EFTA as a

group. Recent developments in Chinese economic relations with Iceland and Norway demonstrate that China now seems to prefer bilateral FTA with the EFTA-members.

**Iceland has become the first European country to launch a FTA feasibility-study with China.** After Iceland recognized China's full market economy status, which is a prerequisite for any FTA-negotiation with China, the study started in May 2005 and was concluded in July 2006. Negotiations concerning the FTA started in April 2007, a fourth round of negotiations took place in April 2008. **In March 2007 Norway also announced to recognize China as a full market economy.** The FTA feasibility-study has been completed and negotiations were launched this September.

As both the position of China as an economic partner for Switzerland and the number of FTA between China and other industrial countries will increase, the potential for discrimination will follow the same path unless progress is made in the Doha Round or Switzerland-China FTA plans materialize. On the occasion of the official visit of **Federal Councillor Leuthard to China in July 2007 a joint declaration on economic cooperation** was signed. The declaration shall strengthen the bilateral relations on trade, investment and intellectual property rights. Further Switzerland has **recognised China as a market economy.** Both sides agreed to conduct **internal feasibility studies towards a possible Free Trade Agreement.** These studies will investigate if the conditions for an FTA are given. **Two Memorandums of Understanding (MoU)**, one on **Investment Promotion** and one on **Intellectual Property**, were concluded during the 17<sup>th</sup> meeting of the Sino-Swiss Joint Commission taking place at the end of May 2007. The implementation of these two MoU's is a first step to the fulfilment of the Joint Declaration. The second meeting of the working group on intellectual property rights will take place end of November, 2008.

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### 3. Foreign trade

#### 3.1 Development and general outlook

##### 3.1.1 Trade in goods

Despite the economic downturn in China's most important export markets the country's export growth remained impressive. In the first nine months of this year **China's trade surplus reached US\$ 181.0 billion**, a decline of US\$ 4.7 billion over the same period last year. However, exports are expected to slow significantly in the coming quarter.<sup>17</sup>

From the period from January to July 2008 **China's most important export markets** were the EU (20.6% of total exports), the United States (17.5%), Hong Kong (13.5%) and the ASEAN-countries (8.3%). For the same period **China's most important import sources** were Japan (13.2% of total imports), the EU (11.5%), the ASEAN-countries (10.6%) and South Korea (10.0%).

For the same period, China's most important trading partners were the EU (16.4% of total trade), the United States (12.8%) and Japan (10.5%).

According to Chinese statistics, exports to Switzerland grew by 23.1% (US\$ 2.4 billion) from January to July while imports from Switzerland grew by 42% (US\$ 4.25 billion).

Recently, news about thousands of SMEs closing down in Guangdong have become more frequent. Though, so far overall exports have not been falling and there's no significant decline in employment in Guangdong.<sup>18</sup> Also, the General Administration of Customs announced in October that more than one half of the total of toy-exporters operating at the beginning of the year had closed by the end of July. Because most of the large producers stayed in business, total toy exports from January to July were 1.3% higher than in the same period last year. Although Chinese officials emphasize that the manufacturing sector should move up the value chain, they are worried about the massive restructuring in such a short time.<sup>19</sup>

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<sup>17</sup> National Bureau of Statistics of China: Steady and Fast Growth in the First Three Quarters of 2008, 20 October 2008.

<sup>18</sup> UBS Investment Research, 15 October 2008.

<sup>19</sup> EIU Country Report, November 2008.

## 3.2 Bilateral trade

### 3.2.1 Trade in goods<sup>20</sup>

In the first nine months of this year **Swiss exports to China** (according to Swiss customs data) **grew by 20.37% to CHF 4.66 billion**. In the same period imports went up by only 3.94% (CHF 3.72 billion) resulting in a trade surplus of CHF 931.97 million for Switzerland. For the same period in 2007, exports were growing at a rate of 30.12% and imports at a rate of 22.18%. The decline in imports is mainly due to a decline in the import of energy carriers and precious metals, as China has introduced stricter rules for the export of these products. Combining the trade data of mainland China and Hong Kong, Switzerland reached a trade surplus of CHF 4.27 billion compared to a trade surplus of CHF 3.35 billion for the same period in 2007. In the first three quarters total trade (mainland China and Hong Kong) amounted to CHF 14 billion, a year-on-year growth of 15.22%.

The most important imports of goods out of China are machinery, apparatus and electronics (Jan. – Sept. 2008 share of imports: 25.4%), textiles, apparel and shoes (18.04%), chemicals and pharmaceuticals (14.13%) and precision instruments, watches and jewellery (13.8%). Exports are dominated by machinery, apparatus and electronics (Jan. – Sept. 2008 share of exports: 38.11%), precision instruments, watches and jewellery (20.11%) and chemicals and pharmaceuticals (19.05%).

In the first three quarters of 2008 Swiss exports to China saw a CHF 182.8 million (growth compared to the same period last year: 11.48%) increase for machinery, apparatus and electronics, a CHF 290.0 million increase for precision instruments, watches and jewellery (44.85%) and a CHF 226.2 million increase for chemicals and pharmaceuticals (34.22%). The most important import goods from China, machinery, apparatus and electronics increased by CHF 72.9 million (8.33%) while imports of textiles, apparels and shoes experienced an increase of CHF 10.8 million (1.63%).

China is a priority country in the framework of Swiss exports promotion and, as can be seen by the areas which experienced strong increases in exports so far in 2008 (machinery, precision instruments, watches and jewellery, chemicals and pharmaceuticals) **Switzerland has a great comparative advantage in sectors which matter to Chinese importers**. One example is the constant and increasing demand for advanced technology and production equipment linked to the progress of China's manufacturing sector and its development of infrastructure across the country. This sector offers and will continue to offer excellent prospects to Swiss producers of machinery and manufacturing instruments, also bearing in mind that the business-cycle has peaked in some areas.

The shift of life-style and consequently of consumer behaviour among wealthier urban citizens to a more westernised consumption pattern has created an **increasing demand for established and high quality brands and luxury items** – from packaged foods to branded clothes to luxury watches. On the one hand, this is an excellent prospect for Swiss brands and goods to tap in a booming market; on the other, **forging and pirating reduces the potential of this market** and bites into profits of various industries. The opening up of the domestic retail banking market to foreign invested financial institutions in December 2006 (the end of the 5 year WTO-rules implementation timetable, cf. chapter 2.1), creates more opportunities for Swiss financial services. Reliable figures on bilateral exchange in the service industries are still unavailable.

Swiss companies often mention that the Chinese market is important and growing and becoming more and more attractive as there are improvements in the business environment (in particular for services, for which the market is still opening). However, the Chinese market remains challenging for foreign companies: the climate is extremely competitive, there are still many restrictions, the regulatory environment is complicated and, for the future, costs are increasing. There were also a few complaints from SME that their **problems are not being taken seriously** by the Chinese authorities, in particular in IPR-protection. Further, many companies see the **East and South-East Asian region as an important market for goods produced in China** with significant potential especially if China eases the logistics channels for export.

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<sup>20</sup> The figures discussed in this section can be found in annexe 4.

## 4 Direct investments

### 4.1 Development and general outlook

The Chinese Government puts a lot of effort at every level and is very successful in attracting foreign investment. In many fields, it was only following the WTO-accession that foreign investors were allowed to carry out direct investments, in particular in the sector of financial services. **Foreigners are still excluded or confined to a minority participation in particularly sensitive or strategic sectors** of the economy. The withdrawal of capital and profits from China is possible, but barriers remain and make the process complex and tedious for businesses.

On 9 November 2006, China's **11<sup>th</sup> five-year programme (2006-2011) for utilizing foreign investment** was published. As one of the most top-ranking foreign direct investment (FDI) recipients, China has decided to shift its policy of attracting foreign business from "quantity" to "quality" and to push its industry up the value chain. Also, foreign-invested companies will no longer enjoy preferential policies in the coming years regulated in the new corporate income tax law where corporate tax-regimes have been unified. These measures address a certain fear of "emerging monopolies by foreign businesses in certain industries which are posing a potential threat to China's economic security", as reported by the State media. Members of the foreign business community recently expressed their concern about the **implications of raising "economic nationalism"** and measures laid down in the Government's FDI-strategy: development of local markets and independent innovation aimed at reducing reliance on external demand, technology and capital in the long run.

Due to the underdeveloped state of Chinese stock markets and because the national currency isn't fully convertible, **foreign investment is 90% direct investment**, and very often greenfield-investment. This system constrains foreign investors but leaves China less vulnerable to attacks on international financial markets as it makes capital withdrawals from direct investments more difficult to arrange. The acquisition of state owned enterprises (SOEs) by foreign investors was made possible under certain conditions in the spring of 2004. The goal is to create an actual market for mergers and acquisitions (M&A). However, as a recent OECD-project on cross-border mergers and acquisitions, co-financed by Seco, has shown, "the regulatory framework for cross-border M&A remains fragmentary, over-complex and incomplete."<sup>21</sup> **Amended foreign Mergers & Acquisitions (M&A)-regulations have entered into force on 8 September 2006.** Although the foreign business community has welcomed the new regulations as they somewhat clarify the complex regulatory environment, concerns have been raised about the use authorities will make of their new competences: Acquisitions of a target company in a key industry, acquisitions which might affect national economic security or acquisitions which involve a change of control of a famous trademark or established Chinese brand must be reported to the Ministry of Commerce. Failing with this requirement could entail termination or reversal of the deal. Future acquisitions may well be subject to much tighter control and further scrutiny by the Chinese Government. A lack of clarity on terms such as "key industry" and "national economic security" has reinforced those fears. However, some commentators do not agree with the general view that we are **witnessing a "backlash"** but claim that nationally sensitive sectors such as defense and media as well as large state owned enterprises have always been off-limits to foreign investors. As China opens up new avenues for privatization and M&A involving big state companies **certain prudence by Chinese authorities only seems normal** to those observers.

The loosening of legal regulations and the awareness that various joint ventures (JV) have experienced difficulties with their Chinese partners has influenced more and more foreign investors to tend towards establishing wholly foreign owned enterprises (WFOE). The transformation of an existing JV into a WFOE is time and again attempted, but is in general constrained by considerable administrative and high (compensation) costs. After measures to administrate international investment in the area of trade and changes to the laws on foreign trade came into force on 1 June and 1 July 2004 respectively, **foreign investors have been authorized to set up and run WFOE in the areas of distribution, retail trade and wholesale since 11 December 2004.**<sup>22</sup>

<sup>21</sup> China: Open policies towards mergers and acquisitions, OECD Investment Policy Reviews, Paris, 2006.

<sup>22</sup> Cf. Administrative method for foreign investment in the commercial sector of the PRC: [http://www.prorenata.com/consulting\\_services/investment/en\\_foreign\\_investment\\_areareg.pdf](http://www.prorenata.com/consulting_services/investment/en_foreign_investment_areareg.pdf)

Although the Government acknowledges the crucial importance of the private sector for the further development of the Chinese economy, in particular in creating employment, **private businesses, with or without foreign participation, still feel put to a disadvantage compared to SOEs.** Instead of having freedom of trade, it is still standard practice in China that any business activity remains unauthorized until it is explicitly and officially approved of. Thus many firms practice their activities in a legal grey area intentionally brought about or at least tolerated by the local authorities, but this understanding can be ended at any time.

From Jan. to Sep. 2008, **foreign businesses invested US\$ 74'373 million in China, up 39.85% from the previous year.** The number of foreign projects approved by the Chinese authorities decreased 26.25% to 20'801 (28'206 in 2007).

Since the beginning of the policy reforms, over 400'000 businesses with foreign participation have established themselves in China. Over 23 million Chinese representing about 10% of the urban labour-force work in businesses with a foreign participation.

**China's industrialisation is mainly fuelled by foreign businesses' investments,** in particular out of Hong Kong and the ASEAN region. 44.45% of FDI came from Hong Kong during the period from Jan. to Sep. 2008, making it by far the most important national origin (US\$ 33'061 million). A considerable proportion of the investments from Hong Kong come from businesses that left China in the first place for tax purposes and now reinvest to the mainland. The same cycle occurs with the Virgin Islands (the second most important national origin of investment with 18.27% from Jan. to Sep. 2008). **During Jan. to Sep. 2008 Singapore, Japan and South Korea were the next largest foreign investors (4.51%, 3.92% and 3.32% respectively), whereas FDI from South Korea decreased 17.09%. During the same period, Switzerland's share of new FDI in China amounted to US\$ 220 (US\$ 299 million in 2007).**

## 4.2 Bilateral investment flows

**At present, about 300 Swiss firms with over 700 branches are represented in China, employing around 55'000 people.** Swiss direct investments in China in 2006 amounted CHF900 Mio.,<sup>23</sup> making Switzerland one of the most important national origins of FDI. Following indications of the Ministry of Commerce (MofCom), China granted 82 (97 in 2007) projects with Swiss participation in 2008 (Jan.-Sep.) with an amount of US\$220 Mio.

Switzerland has economic agreements with China regarding investment protection, mixed credits and avoidance of double taxation. The investment protection agreement between the two States is currently under ratification. **Representative data about the success rate of Swiss or other FDI does not exist** because the companies avoid disclosing such information. However, **around two thirds of Western companies active in China claim nowadays to be profitable.**

A large majority (over three quarters) of the companies that replied to the Seco-survey mentioned in section 3.2.1 are planning on expanding their business or currently doing so. Several specified that they have **completed the infrastructure investment** and now intend to **widen the scope of their business.** They see the market as growing and promising. The fast development of the service sector is seen as an opportunity for business to improve.

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## 5 Trade, economic and tourism promotion "Country advertising"

### 5.1 Foreign economic promotion instruments

The Chinese leadership regulates all the country's economic activities to the detail and since the state remains the owner of whole areas of the industry, it is also one of the most important actors of the economy. **Regular contact with the authorities at every level is thus crucial for Swiss companies established in China.** Further, the official representations of Switzerland – the Embassy in Beijing, and the Consulates General in Shanghai, Guangzhou and Hong Kong– have to take on a particular role in the arrangement of such contacts.

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<sup>23</sup> [http://www.snb.ch/de/mmr/reference/report\\_di\\_2006/source/report\\_di\\_2006.de.pdf](http://www.snb.ch/de/mmr/reference/report_di_2006/source/report_di_2006.de.pdf)

### **Swiss Business Hub China (SBH China)**

The SBH China is part of the worldwide “OSEC Business Network Switzerland” and has been operational since March 2002 at the Swiss Embassy in Beijing with a branch at the Consulate General in Shanghai and a branch at the Consulate General in Guangzhou. The specially trained consular and local SBH-staff offer much needed **services to Swiss SME in their endeavours of strengthening and developing their business relations with China** (services include: market and product analyses; search of distributors, representatives and import partners; individual consulting and coaching; reports on presentation and trade fairs).

### **Osec – Switzerland Trade and Investment Promotion**

Following the growing importance of Sino-Swiss economic exchange, Switzerland Trade and Investment Promotion (the successor out of the merger between Location Switzerland and Osec), the Swiss Government agency responsible for supporting inward investors, has commissioned the consultancy firm Generis AG, Schaffhausen, to manage the promotion of Switzerland as a business location to potential Chinese investors. Switzerland Trade and Investment Promotion pursues business development activities in close consultation and collaboration with the diplomatic and consular missions in Beijing, Shanghai, Guangzhou and Hong Kong and has increased coordination with representatives of cantons active in China. The aim is to build on the firm Sino-Swiss relationships which have been established and **raise awareness of Switzerland as a first-class business location among Chinese business owners, entrepreneurs and investors.**

### **Swiss-Chinese Chamber of Commerce and SwissCham China**

Swiss-Chinese Chamber of Commerce and SwissCham China are private organisations of associations registered in Switzerland and China respectively. Among their members are the leading Swiss companies in the trade, industry and financial sectors. The network consists of about 800 companies and individual members. The Swiss-Chinese Chamber of Commerce was first set up in Zurich in 1980 and established a branch in Beijing in 1995. The latter obtained the status of an independent chamber of commerce according to Chinese law in 2001. As a result, two national organizations are operated today with three regional branches in Switzerland (Zurich, Geneva, Lugano) and three in Beijing, Shanghai and Guangzhou. **Their purpose is to promote and support the global success of the Swiss business community in China.** Simultaneously, SwissCham China assists a growing number of China-based enterprises in their dealings with Swiss partner companies.

Of course there are also a number of experienced private consultants which are offering similar services to interested clients.

## **5.2 Interest for Switzerland as a location for tourism, education and other services, potential for development**

### **Presence Suisse**

Swiss awareness in China is raised through a number of projects including cultural, artistic and architectural ones. The image that is being depicted by Presence Suisse is one of an innovating country placing values such as quality and well-being as key. **Switzerland enjoys a positive, although largely stereotypical image in China.** The goals of Presence Suisse are thus to bring further awareness and understanding of Switzerland to the population in China in order to create stronger relations while the country continues to gain importance in the global economy. During this summer's Olympic Games, Presence Suisse and its partners, Lucerne Tourism and Lake Lucerne Region established the “House of Switzerland” in Beijing's art district. During 24 days more than 120'000 visitors took the chance to visit this official guesthouse where Switzerland was presented to local and international guests. The next upcoming important event will be the 2010 World Expo in Shanghai. Besides this, Presence Suisse, in close cooperation with private and public institutions, is involved in several smaller projects positioning Switzerland as an innovative, internationally minded country with a high quality of life and environmental awareness.

## Tourism

A consequence of the growing Chinese economy and the rise of (urban) incomes is the **booming tourism industry** for travel outside of China: More than 34.4 million Chinese travelled abroad in the first three quarters of 2008, up 14.8% to the same period last year.<sup>24</sup> Therefore China is a key future market for the Swiss tourism industry. Switzerland was granted **Approved Destination Status (ADS)** by the Chinese Government in 2004. Following the implementation of the policy, there was a noticeable increase in accepting visa applications. New checks and guidelines were at the same time put into place to reduce the risk of travellers remaining in Switzerland illegally.

From January to September 2008 95'539 visa were issued to Chinese citizens, a drop of about 6% compared to the same period in the previous year. **Switzerland's entry to the Schengen-Agreements, which should become operational at the beginning of December 2008<sup>25</sup> is expected to be further beneficial:** Swiss Tourism anticipates over 316'000 Chinese overnights in Switzerland by the end of the year 2009<sup>26</sup>. Swiss Tourism was established in Beijing in 1998 and a second branch opened in Shanghai in August 2008. The launch of a direct air link between Zurich and Shanghai in May this year is expected to further boost Chinese outbound tourism to Switzerland.

## Education

In 2002, the Swiss and the Chinese Governments renewed their "Memorandum of Understanding" for **educational exchanges**, and during her October 2006 visit to China, Swiss Foreign Minister Micheline Calmy-Rey signed another MoU, focussing on increased scientific cooperation. In April 2007 State Secretary Kleiber signed a joint statement which proposes a four years (2008-2011) Swiss-Chinese science cooperation strategy for education science and research. The strategy aims at strengthening the cooperation between Swiss and Chinese universities and fostering cooperation in the field of vocational education. Further, the feasibility of a general Memorandum without time limits will be examined. Currently, 18 Chinese and 18 Swiss students have the opportunity to study in the corresponding partner country with a full-time scholarship.

Though the (private) school sector has shown increasing interest in attracting Chinese students to its institutions, the overall number of student visa demands has gone down in recent years. This is partly due to the high costs, perceived limited benefit of studying abroad and bad publicity due to abuses which have taken place in some hotel and tourism management schools. In order to tackle these issues and to promote a positive image of Swiss colleges and universities in China, the Education Section of the Swiss Embassy participated for a second time at the China International Education Exposition in October 2008. As this proved to be an effective way for direct contacts with the relevant media, participation at this exposition will very likely be pursued further.

**In order to strengthen bilateral cooperation in the field of higher education, Swissnex**, an initiative of the Swiss State Secretariat for Education and Research, the Ministry of Foreign Affairs and the Ministry of Home Affairs, officially **opened an office in Shanghai on 7 August 2008**. Swissnex Shanghai will fully exploit the potential of cooperation in the areas of research, technology, innovation and culture.

## **5.3 Interest for Switzerland as a location for investment, potential for development**

Investment flows from China to Switzerland have so far been modest with Chinese capital investment mainly in trading companies and SME, notably in the service and hospitality industries. Switzerland's strengths as an investment location are promoted in China by Switzerland Trade and Investment Promotion ([www.locationswitzerland.ch](http://www.locationswitzerland.ch), also presented in Chinese, cf. section 5.1), the cantons and increasingly by the service sector. Switzerland Trade and Investment Promotion, who carries out systematic market analysis and development has organised some high-level seminars, elaborated brochures, manuals and presentations, assists cantons in their own endeavours in the very demanding Chinese market. Switzerland is most actively advertised with emerging globalizing Chinese companies as a location for international headquarters and business control centres. Cooperation opportunities with the very innovative export-oriented Swiss economy are also

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<sup>24</sup> Xinhua, 23 October 2008.

<sup>25</sup> The expected date of accession is 12 December, as set by the Federal Council. However, the EU Council of ministers will decide in mid-November if and when Switzerland will access the Schengen area.

<sup>26</sup> Swiss Tourism Beijing (STB), 10 April 2008: There were 230'000 Chinese overnights in Switzerland at the end of the year 2007. STB estimates an increase of 10% and 25% by the end of 2008 and 2009 respectively.

highlighted. With a number of recent Chinese investments in different parts of Switzerland **the joint efforts of Switzerland Trade and Investment Promotion the cantons and the service sector have already generated results**. Main competitors in Europe include Belgium, France, Germany, the United Kingdom, the Netherlands and Sweden. Like in other Asian countries Switzerland is perceived as a premium location in the heart of Europe, but high living-costs and barriers for entry of Chinese workforce are on the flip-side.

#### **5.4 Interest for Switzerland as a financial location, potential for development**

Switzerland's reputation as a financial location – as far as there is such a perception among the general public - is generally positive, especially with the Chinese Government, the National Bank and the regulatory bodies of the financial sector. Bilateral financial consultations amongst relevant authorities started in 2005. The Swiss Banking Association initiated a constructive dialogue with Chinese financial authorities in 2006 on issues of mutual interest to Chinese and Swiss financial services industries. So far both, the President of the Governing Board of the Swiss National Bank and the Chairman of the Swiss Banking Association have met high-level financial authorities in Beijing. The leading Swiss banks, which have acquired minority participations in Chinese banks and insurance companies, regularly receive Chinese officials and financial sector professionals for trainings and know-how exchange.

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### **6 Useful internet Links (cf. Annexe 6)**

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#### **Annexes**

**Annexe 1: Structure of the Economy**

**Annexe 2: Essential Economic Data**

**Annexe 3: Trading Partners**

**Annexe 4: Bilateral Trade Switzerland –China**

**Annexe 5: Foreign Direct Investment**

**Annexe 6: Useful internet links**